WC 05-342

STAMP & RETURN

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules.

WC Docket No. 05-________

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Federal Communications Commission
Office of Secretary

PETITION FOR FORBEARANCE

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BELLSOUTH TELECOMMUNICATONS, INC.'S PETITION FOR FORBEARANCE

I. INTRODUCTION AND SUMMARY

Pursuant to 47 U.S.C. § 160 and 47 C.F.R. § 1.53, BellSouth Telecommunications, Inc., on behalf of itself and its affiliates ("BST" or "BellSouth"), respectfully requests that the Commission advance the public interest by granting forbearance from its cost assignment rules.[1] When it comes to these rules, the Commission's 2001 diagnosis is correct: "the question is not whether further deregulation should occur, but rather when." Because the Commission's cost assignment rules create a regulatory chokepoint in the development of broadband networks and services, the time for that deregulation is now. As the Commission recognized in the *Wireline Broadband Order*, fundamental changes in the "technology used to build networks, and the

[1] The rules that are the subject of this Petition are Parts 32.23, 32.27, and 64 Subpart I (referred to as "cost allocation rules"); Part 36 (referred to as "jurisdictional separations rules"); Part 69, Subparts D and E (referred to as "cost apportionment rules"); and other related rules that are completely derivative of or dependent on the foregoing rules. Appendix 1 contains a detailed listing of each specific rule from which BST seeks forbearance, which are referred to collectively in this Petition as the Commission's "rate-of-return rules" or "cost assignment rules." The Petition also seeks limited forbearance from 47 U.S.C. § 220(a)(2) to the extent this provision contemplates separate accounting of nonregulated costs. However, BST is not seeking forbearance from the Part 32, Uniform System of Accounts ("USOA" or "Chart of Accounts"), or relevant ARMIS reporting requirements in Part 43 of the Commission's rules.

purposes for which they are built" today are "rapidly breaking down the formerly rigid barriers that separated one network from the other."[2] Yet, the cost assignment rules at issue in this Petition stand in the way of technological innovation, efficiency and competitiveness by maintaining a rigid regulatory barrier between "regulated" and "nonregulated" services that technology and consumers no longer recognize.[3]

The cost assignment rules at issue in this Petition are legacies from decades old rate-of-return regulation that originally applied to AT&T prior to divestiture and, post-divestiture, to the Regional Bell Operating Companies ("RBOCs") as well.[4] This rate-of-return regulatory regime premised rate-setting on carriers' costs and, thus, gave rise to the Commission's cost assignment rules.[5] However, in the mid 1990s the Commission and the nine states that regulate BST abandoned rate-of-return regulation and adopted "price cap" regulation instead. By placing a

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[2] *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, et al.*, CC Docket No. 02-33, *et al.*, Report and Order and Notice of Proposed Rulemaking, FCC 05-150 at ¶ 32 (rel. Sept. 23, 2005) ("*Wireline Broadband Order*").

[3] The Commission has intimated its agreement with this assessment, noting that "the technology used to build networks, and the purposes for which they are built, are fundamentally changing, and will likely continue to do so for the foreseeable future .... *Network platforms therefore will be multi-purpose in nature and more application-based, rather than existing for a single, unitary technologically specific purpose.*" *Id.*, ¶¶ 35-40 (emphasis added).

[4] *See In re: Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, ¶ 26 (1990) ("*Second Report and Order*") ("The basic rate of return mechanisms that form the foundation of our current system of regulation were originally designed for the regulation of public utilities decades ago").

[5] *Id.*, 5 FCC Rcd at ¶ 24 ("... extensive attention is placed on carrier costs. Costs enter the accounting system pursuant to our Part 32 [USOA], and are separated into regulated and nonregulated components in processes dictated under our Part 64 Rules. Regulated costs are then separated into their interstate and intrastate components according to the Part 36 rules. For LECs, interstate regulated costs are then allocated among the access elements we have prescribed in our Part 69 rules."); *see also Wireline Broadband Order*, at ¶ 132 ("The rules ... require LECs to apportion, on an account-by-account basis, all of their costs between regulated and nonregulated activities .... Th[e] level of detail paralleled the level of detail in the cost-of-service calculations that LECs performed to develop their rates for interstate access services").

ceiling on prices, price cap regulation provides more transparency and greater consumer and public protection than did the lengthy and contentious process of attempting to divine the "cost" of service.

Importantly, under price cap regulation, the costs derived from the Commission's cost assignment rules have no bearing on whether rates are "just and reasonable." Nevertheless, BST has remained obligated to allocate costs between "regulated" and "nonregulated" services under Part 64 of the Commission's rules, and to file (and update) a Cost Allocation Manual ("CAM"). Likewise, BST has continued to separate its investment and expenses into intrastate and interstate components in accordance with Part 36 of the Commission's rules, and allocate the interstate investment and expenses in accordance with Part 69 of the Commission's rules. Performance of these tasks has had no connection – and certainly no "strong connection" – to BST's rates for almost ten years. [6]

Similarly, the rules at issue are no longer related to the consumer protection goals for which they were designed, such as protecting ratepayers from bearing risks of carriers' nonregulated activities or preventing cross-subsidization between the regulated carrier and its unregulated affiliates. As the Commission recently acknowledged, price cap regulation has "greatly reduced" the "incumbent LECs' incentives to overstate the costs of their tariffed telecommunications services."[7] When, as here, costs are not part of the ratemaking equation, there is no "incentive" to inflate, misallocate or manipulate costs and, thus, the cost assignment rules are not necessary to protect consumers from that behavior or similar conduct.

[6] *See Cellular Telecommunications & Internet Association v. FCC*, 330 F.3d 502, 512 (D.C. Cir. 2003) ("necessary," in the context of forbearance, refers to "the existence of a strong connection between what the agency has done by way of regulation and what the agency permissibly sought to achieve with the disputed regulation").

[7] *Wireline Broadband Order*, at ¶ 133.

Nor do the results of the Commission's cost assignment rules guarantee financial transparency or accountability, which are the province of financial accounting rules, the Securities and Exchange Commission ("SEC"), Sarbanes-Oxley and other requirements detailed below. BellSouth will continue to comply with all the financial accounting rules imposed on public companies by the SEC and will continue to be subject to the Uniform System of Accounts in Part 32 and ARMIS reporting requirements in Part 43 of the Commission's rules. Continued compliance with those rules provides ample information about BellSouth's financial condition, should any regulatory agency need that information.

Granting BST's Petition not only is consistent with the public interest, but advances it. Regulatory chokepoints, like the Commission's cost assignment rules, retard the flow of valued, innovative products and services to the marketplace. For every new broadband service that it seeks to offer, BST must conduct an exhaustive analysis of every part of the network and the other resources used to provide the service to ensure compliance with the Commission's cost allocation and affiliate transaction requirements.[8] The more technologically involved the product or service offering, the more allocation decisions are involved: some complex services, in fact, can require up to 100 separate allocation decisions.

These chokepoints are precisely the sorts of regulatory underbrush that cause the U.S. telecommunications industry to lag behind its global competitors and U.S. consumers to lag behind their global neighbors across a broad spectrum of communication products and services.

[8] The example provided in Appendix 5 details 13 separate cost allocation judgments that were required before BST could offer a service consisting of a single platform to monitor and isolate network trouble called the Intelligent Data Service Unit or "IDSU." It took BST three months to devise a plan to comply with the Commission's cost assignment rules in relation to this service. The allocated cost information was used solely to populate a Commission report that served no ratemaking or other legitimate purpose. Ultimately, the customer tired of the wait and took its business elsewhere.

This regulatory handicap is especially inexcusable when, as here, *the regulations no longer bear a connection to the purposes for which they were conceived and implemented.*

Clearing this regulatory blockage is fully consistent with the public interest. There is no good reason that BST's customers should have to wait while BST's products and services stand in a long, value-depleting line of regulatory cost assignment exercises. And, of course, what BST chooses to produce, how it designs and engineers those products and services, and the investments it makes in support of those decisions, should turn on rational engineering and economic judgments, unaffected by the myriad, often bizarre and routinely uneconomic decisions occasioned by outmoded cost assignment rules. It is time for a better approach.

The Commission recognized as much four years ago when it embraced the elimination of outdated and unnecessary accounting rules. In its *2000 Biennial Regulatory Review*, the Commission affirmed its commitment to preserving only those accounting rules that advance a "valid regulatory interest":

> We read section 11 [of the Communications Act of 1934] to require a review of our regulations with an eye toward achieving Congress's goal, in the 1996 Act, of a truly 'pro-competitive, deregulatory' national policy framework for the telecommunications industry. *We recognize that any unnecessary regulation places a corresponding, unnecessary burden on the carriers that are subject to it.*
>
> . . .
>
> Under the direction of the 1996 Act, we are moving to an environment in which *competition will be the main force that sets rates*. Thus, we come to our statutory task with the approach that we will not retain a particular regulation *unless it advances a valid regulatory interest.*[9]

[9] *2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2; Amendments to the Uniform System of Accounts for Interconnection; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*, CC Docket Nos. 00-199, 97-212, 80-286 & 99-301, *Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286; Further Notice of Proposed Rulemaking in CC*

Such statements underscore the Commission's recognition that, when the rationale for its accounting rules has been displaced, those rules can harm the very policy goals that the Commission has set today to promote competition.

The Commission acknowledged that its "accounting and cost allocation rules [needed] to be streamlined" when it began a "broad and comprehensive review of its accounting and reporting requirements."[10] This review initially was a two-phase project, with the first phase focusing on accounting and reporting requirements that could be eliminated or streamlined to provide immediate relief, while Phase Two focused on long-term changes.[11] As part of Phase One, the Commission streamlined affiliate transactions rules, eliminated certain Part 32 accounts, and limited certain ARMIS reporting requirements.[12] The Commission made additional modifications in the *Phase 2 Order*. The streamlined processes have now been in place for

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Docket Nos. 00-199, 99-301, and 80-286, 16 FCC Rcd 19,911 at 19,913 (2001) (emphasis added) (internal citation omitted) ("*Phase 2 Order*" or "*2000 Biennial Regulatory Review*").

[10] *1998 Biennial Regulatory Review – Review of Accounting and Cost Allocation Requirements; United States Telephone Association Petition for Rulemaking; Implementation of the Telecommunications Act of 1996; Accounting Safeguards under the Telecommunications Act of 1996; Petition for Forbearance of the Independent Telephone & Telecommunications Alliance; Petition for Rulemaking to Amend Part 32 of the Commission's Rules, Uniform System of Accounts for Class A and Class B Telephone Companies, to Adopt the Accounting for Software Required by Statement of Position 98-1*, CC Docket Nos. 98-81 & 96-150; ASD File No. 98-64; AAD File No. 98-43; RM-9341, *Report and Order in CC Docket No. 98-81, Order on Reconsideration in CC Docket No. 96-150, Fourth Memorandum Opinion and Order in AAD File No. 98-43*, 14 FCC Rcd 11396, 11399, ¶ 6 (1999) ("*Phase 1 Order*"). The Commission began its accounting review pursuant to its obligations under 47 U.S.C. § 161.

[11] *Id.* at 11399-00, ¶ 6.

[12] *See Phase 2 Order.*

several years, and there has been no negative impact on the public or the ability of regulators to fulfill their statutory duties.[13]

Indeed, in 2001, the Commission conceded that "[m]any of the regulations that we review ... survive from the time of the government-sanctioned monopoly provider, when the Commission's main function was rate regulation, which required extensive accounting and reporting information."[14] Furthermore, according to the Commission, "... the question is not whether further [accounting and reporting] deregulation should occur, but rather when."[15]

BST submits that the time for relief from the Commission's cost assignment rules is *now*. BST's Petition provides granular proof that: (1) the Commission's cost assignment rules have no usefulness, either for ensuring the justness and reasonableness of BST's rates or for protecting consumers; and (2) continued compliance and enforcement would be contrary to the public interest by usurping significant BST resources that could be deployed for activities that produce consumer benefit and by diminishing BST's ability to compete effectively in today's rapidly evolving broadband and IP environment.

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[13] The Commission has initiated a Phase Three review, noting that "as regulatory, technological, and market conditions continue to change, the Commission must consider more drastic changes to existing accounting and reporting requirements." *2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2 and Phase 3*, CC Docket No. 00-199, *Notice of Proposed Rulemaking*, 15 FCC Rcd 20568, 20601, ¶ 87 (2000). The comment cycle has completed, but no order has been issued.

[14] *Phase 2 Order* at 19913, ¶ 3.

[15] *Id.* at 19985, ¶ 206. After release of the *Phase 2 Order*, which provided streamlining of certain accounting rules, the Commission implemented a Federal-State Joint Conference on Accounting Issues (Joint Conference). The Joint Conference raised "concerns" about some of the streamlining from the *Phase 2 Order*, and accounting deregulation in general. The Joint Conference's concerns, as discussed more fully below, are misguided and do not prevent the Commission's granting of this Petition.

The Commission can no longer ignore the regulatory changes that have occurred in ratemaking policy, the competitive reality of the marketplace the Commission seeks to safeguard, and the increasingly integrated networks and services that technology and IP have enabled.[16] Consistent with its recognition that the regulatory focus has changed and because the rules in question no longer serve any legitimate purpose for a price cap carrier like BST, the Commission should continue on the path toward "accounting and reporting deregulation." The next step on that path should be the Commission's granting of BST's Petition for Forbearance.

II. LEGAL STANDARDS FOR FORBEARANCE

This Petition must be granted if the "three prongs" of the forbearance statute, 47 U.S.C. § 160 (a), are satisfied:

> the statutory test for forbearance under [Section 160 (a)] has three prongs that must all be satisfied before the Commission is *obligated* to forbear from enforcing a regulation or a statutory provision: (1) 'enforcement . . . is not necessary to ensure that the charges . . . are just and reasonable and are not unjustly or unreasonably discriminatory'; (2) 'enforcement . . . is not necessary for the protection of consumers'; and (3) 'forbearance . . . is consistent with the public interest.'[17]

Thus, for purposes of this Petition, if it is shown that the rules at issue are not necessary for ratemaking and are not necessary for protecting consumers, and, that granting forbearance is consistent with the public interest, the Commission *must* grant forbearance.

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[16] *See In the Matter of Petition for Waiver of Pricing Flexibility Rules for Fast Packet Services, Petition for Forbearance Under 47 U.S.C. Section 160(c) from Pricing Flexibility Rules for Fast Packet Services*, WC Docket No. 04-246, *Memorandum Opinion and Order* at ¶ 15 (October 14, 2005) ("The price cap system, adopted in 1990, was designed to replicate some of the efficiency incentives present in competitive markets and to act as a transitional regulatory mechanism en route to full competition.")

[17] *CTIA*, 330 F.3d at 509 (emphasis added). *See In the Matter of Petition for Forbearance from E911 Accuracy Standards Imposed on Tier III Carriers for Locating Wireless Subscribers Under Rule Section 20.18 (H), Order*, WT Docket No. 02-377, 18 F.C.C. Rcd 24648, 24653 (2003).

The D.C. Circuit, in accord with this Commission, has observed that the term "necessary" as used in the forbearance context (as opposed to its other statutory uses in the Communications Act), does not mean "absolutely required."[18] However, in the context of forbearance, regulatory requirements should not be deemed "necessary" unless there is a "*strong connection* between what the [Commission] has done by way of regulation and what the agency *permissibly sought to achieve* with the disputed regulation."[19]

What must be sought in the Commission's review of this Petition, then, is affirmative and dynamic, and not merely passive or neutral. Is the enforcement of the rules -- today and going forward – "strongly connected" to what the Commission "permissibly sought to achieve" with the rules when it implemented them? Put differently, the issue is whether continued enforcement *positively* achieves the Commission's permissible regulatory aims in implementing them; if so, then the rule is "strongly connected." If the rules do not achieve the "permissible" regulatory aims, or if the aims no longer exist, no "strong connection" exists. And, of course, when continued enforcement actually produces *negative* results, then an entirely impermissible *negative* "connection" is revealed. In either case, consistent with the public interest, forbearance must be granted.

Thus, BST's Petition cannot be overcome by claims that the rules are vaguely beneficial, or that the rules are "not unhelpful" to those ends, or that the rules are helpful to some broader array of evolving goals whose connections to the rules' original purposes are weak or remote. A "strong connection" to just, reasonable and nondiscriminatory BST rates, and to the protection of

[18] *See CTIA*, 330 F.3d at 509-10; *Petition for Forbearance from E911 Accuracy Standards*, 18 FCC Rcd at 24644.

[19] *CTIA*, 330 F.3d at 512 (emphases added). *See also Petition for Forbearance from E911 Accuracy Standards*, 18 FCC Rcd at 24644 ("... in this context, a requirement is 'necessary' for the protection of consumers if there is a strong connection between the requirement and the goal of consumer protection").

consumers, must be shown for continued application of the rules. As demonstrated below, no such connection exists.

III. REGULATORY BACKGROUND

As demonstrated in greater detail below, the cost assignment rules at issue in this Petition are no longer connected (and certainly not "strongly connected") to the legitimate statutory purposes of ensuring that BST provides service at just and reasonable, nondiscriminatory rates. To appreciate this position fully, it is important to understand: (1) rate-of-return regulation and the role of cost assignment rules in establishing rates under this regulatory scheme; (2) price cap regulation, under which rates are regulated without regard to costs; and (3) that BST is no longer subject to rate-of-return in any jurisdiction. Against this regulatory backdrop, the merits of BST's Petition become self-evident.

A. Ratemaking Under Rate-Of-Return Regulation

1. How rate-of-return regulation worked

For decades, federal and state commissions regulated the local and long distance rates charged by AT&T and the RBOCs pursuant to rate-of-return regulation. Rate-of-return regulation emanated from the legal principle, established nearly 80 years ago, that regulators were required to allow carriers to charge rates, which, on a prospective basis, would provide an opportunity for carriers to earn a fair return on their property dedicated to public use.[20] The legal principle developed in an era when communications "property dedicated to public use" meant use for only "plain old [regulated] telephone service" provided over analog networks by monopoly providers.

[20] *See Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Hope Natural Gas v. West Virginia*, 274 U.S. 284 (1927).

Rate-of-return regulation was a "cost plus" system which required a carrier to determine the amount of investment in its regulated rate base as well as the expenses the carrier incurred to provide services during the year.[21] Detailed tracking of investment and expense was assumed to be, and was, readily accomplished as long as the networks remained single purpose and analog.[22]

The rate-of-return ratemaking process began with the regulatory agency's establishment of a test period. The test period concept was devised to determine the revenue and expenses that would be *representative* of the rate-effective period. For interstate ratemaking purposes, the Commission's test period was usually a prospective 12-month period, that is, the test period projected revenue and expenses for the immediate 12-month future.[23]

Once the test period was determined, the revenues and expenses for that period were estimated. This was a two-step process. The first step was to determine the projected regulated rate base. The rate base was the carrier's assets that were "used and useful" for providing services and typically included, but was not limited to, the telephone plant held in service, plant in construction, and material and supplies. These amounts would be reduced by accumulated depreciation on the plant and various other adjustments that the regulatory agency required to be backed out of the rate base.[24] Once determined, the rate base was multiplied by the authorized

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[21] *Second Report and Order*, 5 FCC Rcd at 6787 ¶ 1 ("[LECs], in providing the critical telecommunications link between a customer's premises and the interexchange networks, have until now been regulated under a "cost-plus" system . . . in which rates . . . are based on costs plus a return on invested capital.")

[22] The task became more arduous as new technology and deregulatory policies introduced multi-use facilities, a development that has reached a crescendo in today's environment of broadband and IP networks.

[23] *See e.g.*, 47 C.F.R. 61.38(b)(1)(ii).

[24] *See* 47 C.F.R. 65, subpart G, for a description of allowable and disallowable assets a rate of return carrier uses to establish its federal rate base.

rate of return[25] to calculate the return on investment that the carrier would be allowed to achieve for the period.

The next step was to project the operating expenses for the test period. Examples of projected expenses included, but were not limited to, plant specific, plant non-specific, customer operations, corporate expenses, operating taxes, and depreciation. The total operating expenses were then added to the return on investment calculated above to determine the "revenue requirement" for the test period. The revenue requirement was allocated over the types of services in order to establish rates for those services for the upcoming year.

The following example helps illustrate the concept of interstate rate-of-return ratemaking:

Revenue Requirement Calculation
Additions:

Telephone plant in Service	11,000
Plant under Construction	1,000
Materials and Supplies	1,000
Total Additions	13,000

Deductions:

Accumulated depreciation	2,000
Accumulated Deferred Fed. Income Tax	500
Customer Deposit	500
Total Deductions	(3,000)
Regulated Rate Base	10,000

Regulated Rate Base	10,000
Authorized Rate of Return	11%
ROI Component of Revenue Requirement	1,100

Operating Expenses:

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[25] The authorized rate of return is established by various methods sanctioned by the regulatory agency.

Plant Specific	2,000
Plant Non-Specific	500
Customer Operations	1,500
Corporate Operations	100
Sub Total	4,100
Depreciation	1,900
	6,000
Income Tax	400
Total Regulated Expenses	6,400
Total Projected Revenue Requirement For Period (Regulated Expenses + ROI Component)	7,500

Thus, pursuant to these calculations, the carrier would price its service(s) in order to achieve revenue of $7,500 for the upcoming year.

Under rate-of-return ratemaking, regulators used actual regulated costs to monitor a carrier's performance. That is, at the end of the year, a carrier's realized rate-of-return was computed from the actual regulated revenue, investment, and expense amounts for that year. To the extent a carrier realized a rate-of-return in excess of approved levels, the carrier might be required to reduce its rates for the next year by the amount of the over-earning.[26]

Continuing the above example, at the end of the year, if the carrier's actual financial results showed that the carrier had earned a net operating income of $1,400 with an actual regulated rate base of $10,000, the actual rate-of-return would be 14% (1,400/10,000), 3% above the authorized rate. If the regulatory agency required excess earnings to be returned to customers, the carrier would have to adjust its revenue requirement, and its rates, downward the

[26] Under the Commission's rules, a carrier's realized rate-of-return was measured over a two-year period. At the conclusion of the two-year period, if a carrier exceeded the maximum allowable rate-of-return, the carrier had to refund the excess return by lowering rates. *See* 47 C.F.R. § 65.701.

next year to reflect the over-earning in the current year. Conversely, if actual financial results showed a net operating income of $1,100 with a rate base of $10,000, the carrier would have achieved the hypothetically authorized rate of 11% and no adjustment would be necessary.

2. Cost data is necessary under rate-of-return regulation

The explanation of rate-of-return regulation, above, underscores the need for access to accurate historical cost data under this traditional form of regulation. Actual financial results reflecting increases or decreases in historical costs factored directly into the determination of whether rates would be adjusted upward or downward in any given rate cycle. Thus, the Commission – through a gradually evolving regulatory process – wanted to ensure that costs were meticulously monitored and assigned. The cost assignment rules (for which BST now seeks forbearance) served that purpose.

In order for this traditional ratemaking process to be properly monitored at the federal level, the Commission established the USOA. The USOA, first codified in Part 31 but now found in Part 32, established the Chart of Accounts that each company subject to the rules must follow and defined the types of revenue, investment, and expenses that could be recorded in each Commission-prescribed account. Under rate-of-return regulation, these accounts are the starting point for all FCC accounting rules and formed the basis for determining the actual regulated rate base and operating expenses for the year.

Additionally, because the telephone company networks and resources were used to provide both interstate and intrastate services, the Commission developed rules (Part 36 – Separations) to separate investment and expenses into the federal and state jurisdictions. The separations process ensured that the costs flowing into the interstate rate-of-return process were only those costs "used and useful" for providing interstate services. The separations process also was important for state ratemaking purposes, which was uniformly operating under rate-of-return regulation at the time.

Through the *Computer Inquiry* line of cases,[27] the Commission eventually permitted AT&T and the RBOCs to provide "enhanced" or "information" services and determined that, since such services were competitive, they should be treated as "nonregulated." While initially offered only through structurally separate affiliates, these services were subsequently allowed by the Commission to be provided on an integrated basis.[28]

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[27] *Regulatory & Policy Problems Presented by the Interdependence of Computer & Communications Services & Facilities*, 28 FCC2d 291 (1970); 28 FCC2d 267 (1971), *aff'd in part sub nom. GTE Service Corp. v. FCC*, 474 F.2d 724 (2d Cir. 1973), *decision on remand*, 40 FCC2d 293 (1973). *Amendment of Section 64.702 of the Commission's Rules and Regulations*, 77 FCC2d 384 (1980), *recon.*, 84 FCC2d 50 (1980), *further recon.*, 88 FCC2d 512 (1981), *affirmed sub nom., Computer and Communications Industry Ass'n v. FCC*, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983); *Amendment of Section 64.702 of the Commission's Rules and Regulations*, CC Docket No. 85-229, Phase I, 104 FCC2d 958 (1986), *recon.*, 2 FCC Rcd 3035 (1987), *further recon.*, 3 FCC Rcd 1135 (1988), *second further recon.*, 4 FCC Rcd 5927 (1989), (*Computer III Phase I Order and Computer III Phase I Reconsideration Order vacated California v. FCC*, 905 F.2d 1217 (9th Cir. 1990)); Phase II, 2 FCC Rcd 3072 (1987), *recon.*, 3 FCC Rcd 1150 (1988), *further recon.*, 4 FCC Rcd 5927 (1989) (*Computer III Phase II Order vacated California I*, 905 F.2d 1217 (9th Cir. 1990)); *Computer III Remand Proceeding*, 5 FCC Rcd 7719 (1990), *recon.*, 7 FCC Rcd 909 (1992), *pets. for review denied, California v. FCC*, 4 F.3d 1505 (9th Cir. 1993); *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards*, 6 FCC Rcd 7571 (1991), *BOC Safeguards Order vacated in part and remanded, California v. FCC*, 39 F.3d 919 (9th Cir. 1994), *cert. denied*, 514 U.S. 1050 (1995). *See also Bell Operating Companies' Joint Petition for Waiver of Computer II Rules*, 10 FCC Rcd 1724 (1995); *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services*, 10 FCC Rcd 8360 (1995); *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Review – Review of Computer III and ONA Safeguards and Requirements*, CC Docket Nos. 95-20, 98-10; *Further Notice of Proposed Rulemaking, Report and Order*, 13 FCC Rcd 6040 (1998), *Report and Order*, 14 FCC Rcd 4289 (1999), *on reconsideration*, Order, 14 FCC Rcd 21628 (1999).

[28] *See generally In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, 11 FCC Rcd 17539 at 17542-43 (1996) ("*Accounting Safeguards Order*").

The Commission determined, however, that under rate-of-return regulation, costs associated with these integrated nonregulated services should not be borne by regulated ratepayers. Accordingly, the Commission developed a means for companies to allocate costs between regulated and nonregulated operations in the *Joint Cost Order*.[29]

The *Joint Cost Order* established the Part 64 cost allocation rules as an overlay on the Part 32 USOA. All costs were still recorded in the prescribed USOA accounts. But, because carriers were only allowed to use regulated costs for ratemaking purposes, costs had to be allocated between regulated and nonregulated activities before flowing into the separations process and onto the rate-of-return process (either federal or state).

These cost assignment rules, now codified in Parts 32, 64, 36 and 69, established a "four-step regulatory process that began with an ILEC's accounting system and ended with the establishment of rates for the ILEC's interstate and intrastate regulated services" as follows:

> First, carriers record their costs, including investments and expenses, into various accounts in accordance with the . . . USOA . . . . Second, carriers assign the costs in these accounts to regulated and nonregulated activities in accordance with Part 64 of the Commission's rules to ensure that the costs of non-regulated activities will not be recovered in regulated interstate service rates. Third, carriers separate the regulated costs between the intrastate and interstate jurisdictions in accordance with the Commission's Part 36 separations rules. Finally, carriers apportion the interstate regulated costs among the interexchange services and rate elements that form the cost basis for their interstate access tariffs. Carriers perform this apportionment in accordance with Part 69 of the Commission's rules. The intrastate costs that result from application of the Part 36 rules form the foundation for determining carriers' intrastate rate base, expenses, and taxes.[30]

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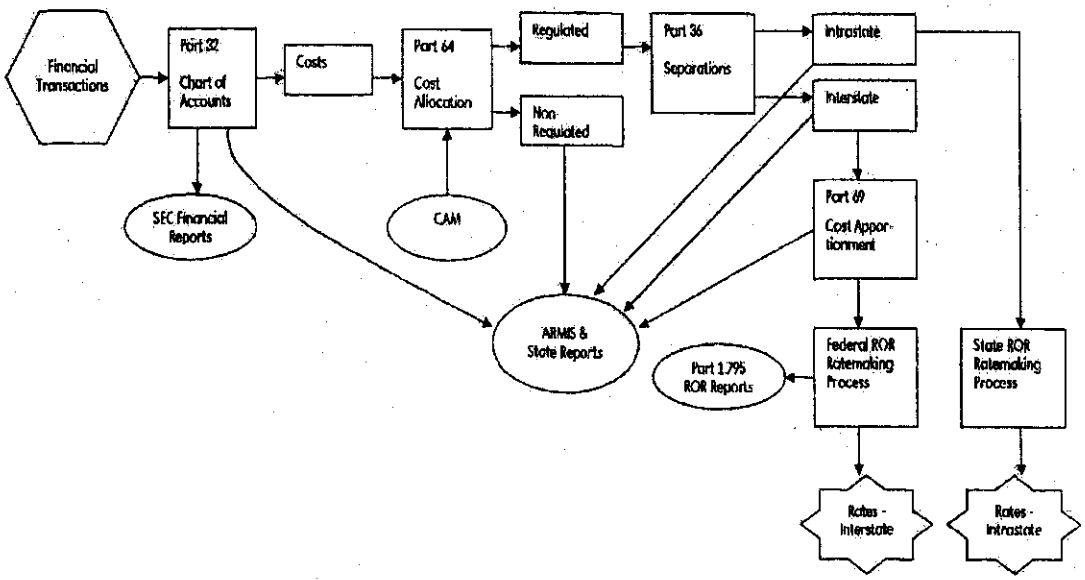
[29] *See Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order*, CC Docket No. 86-111, 2 FCC Rcd 1298, 1330-31 ("*Joint Cost Order*") (1987).

[30] *See Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Report and Order*, 16 FCC Rcd 11382, 11384-85, ¶ 3 (2001), adopting *Recommended Decision*, 15 FCC Rcd 13,160 (2000).

As the Commission states, and as Chart 1 clearly illustrates, the culmination of the cost allocation process under rate-of-return regulation was "the establishment of rates."

1. Cost and Ratemaking Under Rate-of-Return

Under Rate-of-Return, results of cost assignment rules flowed directly into rates.



B. Establishing Prices under Price Cap Regulation.

1. How price cap regulation works

BST has been under totally "pure" price cap regulation at the federal level since 2000.[31] Therefore BST's federally regulated access prices are governed today by the Commission's price cap rules contained in Part 61. Under price cap regulation, an ILEC's prices cannot exceed certain prescribed limits; its costs are irrelevant. For price cap ILECs, price changes are limited by the price cap formula, which incorporates changes in inflation and other non-accounting factors, such as demand changes. These relationships are depicted in the federal price cap formula:

> New year Price Cap Index ("PCI") = Last year's Price Cap [(Inflation - Productivity Adjustment) +/- Exogenous Cost Factor].[32]

Under the FCC's rules, the PCI is currently calculated each year using the Gross Domestic Product Price Index ("GDP-PI") for inflation and a pre-established productivity factor ("X Factor").[33] The PCI also is affected by exogenous changes (costs outside the carrier's control such as new legislation or regulation), which are discussed in more detail below.

The Commission has established a set of baskets for grouping various types of services. These baskets are "broad groupings of LEC services, each of which is subject to its own cap."[34] Multiple service offerings can reside in a given basket. Carriers compare the historic demand multiplied by prospective rates to the revenue cap. Companies can change their tariff rates as

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[31] "Pure" price cap regulation means that the carrier is not subject to a "sharing" component to manage over-earnings or allowed to file a lower formula adjustment for under-earnings. BST was the first ILEC to operate under "pure" price cap regulation when it gave up the lower formula adjustment mechanism ("LFAM") option after being granted pricing flexibility in December 2000.

[32] *See Second Report and Order*, 5 FCC Rcd at 6786.

[33] *See* 47 C.F.R. § 61.45 (a) and (b).

[34] *Second Report and Order*, 5 FCC Rcd at ¶ 11.

market conditions warrant (raise the price of some services, lower the price of others) so long as the total of all services within a given basket are within an acceptable price cap range as defined by Commission rules.[35] Lowering of tariff rates only becomes mandatory when the total of all services in that basket exceeds the price cap.

Finally, ILECs also must calculate Service Band Indices ("SBI") for each category of service within a basket. These pricing bands "permit prices for service categories to increase on a streamlined basis no more than plus or minus 5 percent per year, adjusted for the change in the price cap."[36] Thus, in order for any tariff filing to be deemed "reasonable," the SBI for any service cannot exceed five percent above or below the previous SBI for that service. The API and the SBI were implemented to protect against cross-subsidization between the various baskets of price cap services as well as those services not in price caps.[37] Neither SBI nor API contains any carrier cost element.

Below is an example of how the price cap process works for BST today for a representative price cap basket (*e.g.*, common-line, traffic-sensitive, special access, *etc.*):[38]

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[35] BST must calculate an Actual Price Index ("API") for each basket, which is an index of the level of aggregate rate element rates within the basket. The API cannot exceed the PCI for any basket. There is no carrier cost element in the API determination.

[36] *Second Report and Order*, 5 FCC Rcd *at* ¶ 11.

[37] *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket Nos. 96-262, 94-1 & 98-157, CCB/CPD File No. 98-63, *Fifth Report and Order and Notice of Proposed Rulemaking*, 14 FCC Rcd 14221, 14251 n.144 (1999) ("*Pricing Flexibility Order*") ("[T]he service band indices (SBIs) were designed to limit cross-subsidization between different types of services within a basket ...").

[38] This example assumes pure price cap regulation under which the carrier is not subject to a "sharing" component or allowed to file a lower formula adjustment for below cap earnings.

Price Cap Calculations:

Adjustment to Price Cap Index (PCI)

Current PCI	50.0000
Gross Domestic Product Price Index	3.00%
GDPPI – X	-3.50%
Exogenous Factor[39]	0.00%
Proposed PCI	48.2500

Impact to Basket Revenue

Basket Revenue at Current PCI	$2,000
Current PCI	50.0000
Proposed PCI	48.2500
Proposed Revenue at Proposed PCI	$1,930

In the foregoing hypothetical price cap basket, the prices for multiple services in the basket will be set in order to generate revenues of $1,930.

2. **Cost data is unnecessary under price regulation.**

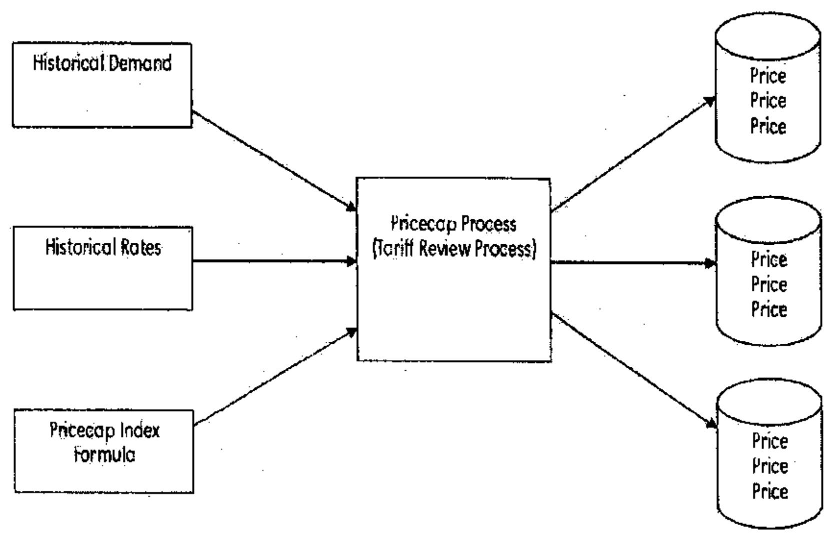
As the above example and Chart 2 clearly illustrate, the inputs into the price cap process do not rely on the results of the cost assignment rules. Unlike the rate-of-return example, when a LEC's costs, and specifically the results of the cost assignment rules, are a critical input that has a direct and meaningful impact on the rates that customers pay, the inputs into the price cap process are governed by economic factors such as productivity and demand. The significant policy realignment from rate-of-return regulation to price cap regulation at both the federal and state levels effectively severed the direct link that was inherent in rate-of-return regulation between carriers' costs and prices for services. In fact, a price cap LEC benefits by keeping

[39] The Exogenous Factor represents costs outside the carrier's control. The Factor can be either a plus or a minus; for example, changes in tax laws could trigger an exogenous adjustment. The adjustment is expressed as a factor representing the adjustment amount divided by the current basket revenue.

costs low (and productivity high) so as to maximize its returns. In short, the shift to price cap regulation fundamentally has obviated the need for the Commission's cost assignment rules.

2. Inputs Into Pricecap Regulation

Results of cost assignment rules do not flow into Pricecap process.



C. <u>Price Regulation in BST States</u>

Shortly after the Commission's 1990 adoption of price cap regulation, all of the states in BST's region likewise shifted from rate-of-return regimes to price cap regulation. Now, in each of BST's states -- Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina and Tennessee – BST operates under "pure" price cap regulation (*i.e.*, the plans do not contain any lower formula adjustment mechanism or similar rate-of-return-dependent component). These state plans are similar to the price cap plan the Commission adopted for interstate rates described above.[40] Like the Commission's plan, BST's state price regulation plans no longer rely on cost information for ratemaking purposes.[41] In migrating to price

[40] A general, state-by-state price cap discussion involving BST's territory is contained in Appendix 2.

[41] *See, e.g., Petition of South Central Bell Telephone Company to Restructure Its Form of Regulation; All Telephone Companies Operating in Alabama, Generic Hearing on Local Competition; Streamlined Regulation of Interexchange Carrier and Reseller Telecommunications Services; Complaint Filed By AT&T Communications of the South Central States, Inc. Against South Central Bell on April 25, 1995*, Docket Nos. 24499, 24472, 24030 & 24865, *Report and Order*, 1995 Ala. PUC LEXIS 571, at *42 (Sept. 1995) ("With price regulation, prices charged to customers become the financial focus of the Commission, rather than the earnings of LECs"); *Application of BellSouth Telecommunications, Inc. d/b/a South Central Bell Telephone Company to Modify its Method of Regulation*, Case No. 94-121, *Order*, at 9 (Ky. Pub. Serv. Comm'n July 20, 1995) ("The Commission finds that implementing a price cap form of regulation for South Central Bell is appropriate with the safeguards it has included and will provide added incentive for the Company to operate its business efficiently"); *Regulations for Competition in the Local Telecommunications Market, General Order*, 1996 La. PUC LEXIS 7, at *71 (Mar. 15, 1996) ("The Price Plan is based on the ILEC's rates for service rather than its rate of return"); *Order of the Mississippi Public Service Commission Establishing a Docket to Consider Formulating a Properly Structured Price Regulation Plan for South Central Bell*, Docket No. 95-UA-313, *Order*, at 2-3 (Miss. Pub. Serv. Comm'n Oct. 31, 2001) (noting that Mississippi's Price Regulation Evaluation Plan adopted in 1995 "fostered an environment where, through the regulation of prices as opposed to earnings, BellSouth has become more market-driven and customer-focused, which is beneficial to both BellSouth and its customers"); N.C. Gen. Stat. § 62-133.5(a) (2005) (noting that under price regulation in North Carolina, the local exchange company is permitted "to determine and set its own depreciation rates, to rebalance its rates, and to adjust its prices in the aggregate, or to adjust its prices for